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IN THE

Supreme Court of the United States

October Term, 1964
No. 63

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

CLAY B. BROWN and DOROTHY E. BROWN, DONALD L. BROWN and INGRID R. BROWN, CHARLES WILLIAM BOOTH and NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF OF AMICUS CURIAE.

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SUBJECT INDEX

	Page
Statement of interest of amicus curiae	1
Opinion below; jurisdiction	2
Issue presented	2
Statutes involved	4
Statement	8
Summary of argument	14
Argument	15
1. Although this was a sale to a charitable buyer it was within sound public policy	15
2. The only viable question is whether a charitable organization should enjoy tax exemption for rental income used to purchase business properties. This is a question of fiscal policy to be answered by Congress	17
3. At the Treasury's instance Congress amended the Internal Revenue Code in 1950 to control the credit purchase of businesses by tax-exempt organizations	18
4. The Commissioner has not accepted the remedy provided by Congress. Since 1954 he has broadly attacked exempt organization credit purchase transactions	21
5. Petitioner contends that for tax purposes respondents made a transfer with income retained, rather than a sale. This is a new issue which may not be presented for the first time in this court	23

Page

6. Petitioner has presented no adequate reason for unsettling the meaning of "sale" in the tax statutes or changing the rule of tax law upon which respondents relied 25

A. "Sale" in the tax statutes should not have an esoteric meaning but should apply to an arm's length sale at substantive law .. 26

B. Petitioner proposes that the pattern of tax statutes relating to sales should not apply to this substantive sale 27

C. The oil interest cases upon which petitioner relies are not analogous to a credit sale of non-depletable property. The tax consequences of the latter cannot sensibly depend upon the buyer's down payment or personal liability 28

D. The substantive sale by respondents was made in reliance upon an historic acceptance of the commercial meaning for "sale" in the tax statutes, particularly the installment sale provisions 34

E. If a remedy is needed, Congress should provide it. Petitioner's proposal for court action would take from an accepted rule of tax law the reliability that it deserves for the future and the integrity that it deserves for the past 37

Conclusion 41

Appendix A—Rev. Rul. 54-420 (1954-2 Cum. Bull. 128) .....App. p. 1

TABLE OF AUTHORITIES CITED

Cases	Page
A. Shiffman v. Commissioner, 32 T. C. 1073, acq. 1960-1 Cum. Bull. 5	22
Albert Vischia v. Com., 26 T. C. 1027	36
Anderson Dairy, Inc. v. Commissioner, 39 T. C. 1027	21
Biscayne Bay Islands Co. v. Com., 23 B. T. A. 731, acq. XI-1 C. B. 2	36
Burnet v. Commonwealth Improvement Co., 287 U. S. 415	25
Burnet v. Harmel, 287 U. S. 103	30
Burnet v. Logan, 283 U. S. 404	35
Burton-Sutton Oil Co. v. Commissioner, 328 U. S. 25	29, 33
C. F. Mueller Co. v. Commissioner, 14 T. C. 922	18
Commissioner v. Southwest Exploration Company, 350 U. S. 308	29
Crane v. Commissioner, 331 U. S. 1	27, 33, 39
Emanuel N. Kolkey v. Commissioner, 254 F. 2d 51 aff'g 27 T. C. 37	22
General Utilities & Operating Co. v. Helvering, 296 U. S. 200	25
Hawley, James L., Estate of v. Commissioner, 20 T. C. M. 210	22
Hawthorne, Cordie, Estate of, 19 T. C. M. 770	22
Helvering v. Flaccus Oak Leather Co., 313 U. S. 247	27, 40
Helvering v. Hammel, 311 U. S. 504	35
Helvering v. O'Donnell, 303 U. S. 370	30, 35
Helvering v. Salvage, 297 U. S. 106	25
Helvering v. Wood, 309 U. S. 344	25
Hormel v. Helvering, 312 U. S. 552	25

Page

Howes, Ernest G., Estate of v. Commissioner, 30 T. C. 909, aff'd sub. nom. Commissioner v. Johnson, 267 F. 2d 382 22

Isis Windows, Inc. v. Commissioner, 22 T. C. M. 837 22

Ives Dairy, Inc. v. Com., 23 B. T. A. 579, aff'd 65 F. 2d 135 36

John W. Commons v. Com., 20 T. C. 900, acq. 1954-1 Cum. Bull. 4 36

Key Largo Shores Properties, Inc. v. Com., 21 B. T. A. 1008, nonacq. X-1 Cum. Bull. 84 36

Knapp Bros. Shoe Mfg. Corp. v. United States, 142 F. Supp. 899 22

Lamberth, E. P., Estate of v. Com., 31 T. C. 302, acq. and nonacq. 1959-1 Cum. Bull. 4 and 6 36

Le Tulle v. Scofield, 308 U. S. 415 35

Morgan Rundel v. Com., 21 B. T. A. 1019 36

Ohio Brass Co. v. Commissioner, 17 B. T. A. 1199, acq. IX-2 Cum. Bull. 45 35

Ohio Furnace Co. v. Commissioner, 25 T. C. 179 .. 22

Oscar C. Stahl v. Commissioner, 22 T. C. M. 996 22

Pacific National Co. v. Welch, 304 U. S. 191 36

Peter Mamula v. Com., 41 T. C. 572 36

Ralph M. Singer v. Commissioner, 22 T. C. M. 759 22

Rialto Mining Corp. v. Commissioner, 25 B. T. A. 980, acq. XI-1 Cum. Bull. 6 35

Roche's Beach, Inc. v. Commissioner, 96 F. 2d 776 .. 18

Royal Farms Dairy Co. v. Commissioner, 40 T. C. 172 22

Sarah Briarly v. Com., 29 B. T. A. 256 36

Saunders v. United States, 101 F. 2d 133 36

Spring City Foundry Co. v. Commissioner, 292 U. S. 182 35

Page

Susie Ackerman v. United States, 318 F. 2d 402 36
The Hanover Bank v. Commissioner, 369 U. S. 672 ..... 27, 39
Thomas v. Peckham Oil Co., 115 F. 2d 685 30
Union Bank, Executor v. United States, 285 F. 2d 126 ..... 21, 22
United States v. Cumberland Public Service Company, 338 U. S. 451 40
Vermont Transit Co., Inc. v. Commissioner, 218 F. 2d 468, cert. denied 349 U. S. 945 35
W. G. Choate v. Commissioner, 324 U. S. 1 30
W. H. Truschel v. Commissioner, 29 T. C. 433, acq. 1960-1 Cum. Bull. 6 22
W. T. Thrift, Sr. v. Com., 15 T. C. 366 36

Miscellaneous

Cumulative Bulletin No. 2, 0.988, p. 84 (1920) 31
General Council Memorandum 12012, XII-2 Cum. Bull. 60 (1933) 35
General Council Memorandum 12148, XII-2 Cum. Bull. 57 (1933) 35
General Council Memorandum 21503, 1939-2 Cum. Bull. 205 35
House Report No. 2319, Ways & Means Committee, 81st Congress, Second Session, 1950-2 Cumulative Bulletin, pp. 380, 480-411 18
House Report 8363, Revenue Bill of 1963 (1964), Report of House Ways and Means Committee, p. 73 38
House Report 8363, Revenue Bill of 1963 (1964), Report of House Ways and Means Committee, p. 91 38
Report of Senate Finance Committee, p. 103 38

Page

Senate Committee Report 2375, 81st Congress, Second Session, 1950-2 Cumulative Bulletin 483, p. 502 et seq 18

Senate Report No. 1622, 83rd Cong. 2d Sess. 64 36

Rulings

Revenue Ruling 54-420, 1954-2 Cum. Bull. 128 ..... 3, 13, 21, 23, 34, 37

Revenue Ruling 55-540, p. 39 35

Revenue Ruling 55-541, 1955-2 Cum. Bull. 19 35

Revenue Ruling 57-371, 1957-2 Cum. Bull. 214 35

Revenue Ruling 58-353, 1958-2 Cum. Bull. 408 35

Revenue Ruling 60-226, 1960-1 Cum. Bull. 26 35

Statutes

California Code of Civil Procedure, Sec. 580(b) 26

California Corporations Code, Sec. 2466 26

Oregon Compiled Laws Annotated, Sec. 78-101 26

Oregon Revised Statutes, Sec. 88.070 26

Public Law 88-570, Sec. 2(a) 37

Revenue Act of 1921, Sec. 206 2

Revenue Act of 1950, Sec. 301 ..... 4, 20

Revenue Act of 1964, Sec. 224 38

Revenue Code of 1939, Sec. 23(a)(1)(A) 35

Revenue Code of 1939, Sec. 23(m) 29

Revenue Code of 1939, Sec. 44 28

Revenue Code of 1939, Sec. 101 20

Revenue Code of 1939, Sec. 111 27

Revenue Code of 1939, Sec. 112 28

Page

Revenue Code of 1939, Sec. 112(a) 27
Revenue Code of 1939, Sec. 112(b) 27
Revenue Code of 1939, Sec. 113(a) 28
Revenue Code of 1939, Sec. 114(b)(3) 29
Revenue Code of 1939, Sec. 117 .....2, 26, 28
Revenue Code of 1939, Sec. 117 (a) 24
Revenue Code of 1939, Sec. 117(a)(4) 4
Revenue Code of 1939, Secs. 117(f)-117(p) 34
Revenue Code of 1939, Sec. 421 20
Revenue Code of 1939, Sec. 422(a)(3) 20
Revenue Code of 1939, Sec. 422(a)(4) 20
Revenue Code of 1939, Sec. 423 20
Revenue Code of 1939, Sec. 1012 28
Revenue Code of 1939, Secs. 1201-1212 28
Revenue Code of 1939 Sec. 1221-1223 28
Revenue Code of 1939, Sec. 1231 28
Revenue Code of 1939, Regulations 118, Sec. 39.44-2(c) 35
Revenue Code of 1939, Regulation 118, Sec. 332 27
Revenue Code of 1939, Regulation 118, Sec. 351 .. 27
Revenue Code of 1939, Regulation 118, Sec. 453 28
Revenue Code of 1939, Regulation 118, Sec. 1001 .. 27
Revenue Code of 1939, Regulation 118, Sec. 1002 27
Revenue Code of 1939, Regulation 118, Sec. 1031 .. 27
Revenue Code of 1954, Sec. 162(a)(3) 35
Revenue Code of 1954, Sec. 165(g) 40
Revenue Code of 1954, Sec. 453(b)(2) 36
Revenue Code of 1954, Sec. 501 8

	Page
Revenue Code of 1954, Sec. 502	8
Revenue Code of 1954, Secs. 511-514	8, 21
Revenue Code of 1954, Sec. 514(b)(2)(B)	20
Revenue Code of 1954, Sec. 611	29
Revenue Code of 1954, Sec. 613	29
Revenue Code of 1954, Sec. 1038	37
Revenue Code of 1954, Sec. 1222	2, 26
Revenue Code of 1954, Sec. 1222(3)	4
Revenue Code of 1954, Secs. 1231-1250	40
Revenue Code of 1954, Sec. 1235	35
Revenue Code of 1964, Sec. 483	38
42 Statutes at Large, p. 232	2
64 Statutes at Large, p. 906	4, 20

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BRIEF OF AMICUS CURIAE.

Statement of Interest of Amicus Curiae.

This brief is filed *amicus curiae* by the undersigned attorney to comment upon the issues involved, and to advise the Court of the inter-relationship of this case with that of *West Los Angeles Institute for Cancer Research v. Commissioner of Internal Revenue*, pending before but not yet tried by the Tax Court in Docket No. 94372. In that case, the undersigned represents West Los Angeles Institute for Cancer Research, formerly known as California Institute for Cancer Re-

search (herein called the "Institute"); the Tax Court will there consider the tax aspects of the Institute's purchase of the stock of Clay Brown & Company from the respondents in this case and one additional party (herein called the "Brown Group").

Opinion Below; Jurisdiction.

These are adequately set forth in the briefs for petitioner and respondents.

Issue Presented.

Stated narrowly, the issue is whether the Brown Group effected a "sale" to the Institute of the stock and notes of Clay Brown & Company, as the word "sale" is used in Section 117 of the 1939 Revenue Code. Petitioner apparently concedes that there was an arm's length sale in form and in legal and commercial substance (Br. 30, 37-38, 56); but contends that for tax purposes there was a transfer with retention of income rather than a sale.

Stated broadly, the issue is whether there shall be a Rule of Tax Law having reliability and integrity for taxpayers.

The first appearance of a special tax rate upon gain from the "sale" or exchange of a capital asset was 43 years ago in Section 206 of the Revenue Act of 1921 (42 Stat. 232). As used there and in the corresponding provision of succeeding Revenue Acts and Codes, including Sections 117 and 1222 of the 1939 and 1954 Codes, "sale" has had its usual commercial and legal meaning. Petitioner now proposes to give it a special tax meaning that will depend upon the degree of economic risk retained by the seller, as that may vary

from case to case. This would create a large area of tax uncertainty for transactions that have enjoyed tax reliability for the past 43 years.

When in 1953, the Brown Group sold to the Institute their securities in Clay Brown & Company, the commercial meaning of "sale" in the capital gain provision had had an historic acceptance of 32 years. If there was any warning to these parties of Treasury attack upon their transaction, it lay not in the statutory meaning of "sale" but in the area of use by charitable organizations of their exempt income to pay a deferred price. The Brown Group and the Institute might logically have been concerned that the rent to be collected by the latter from Fortuna Sawmills, Inc. (herein called "Fortuna"), could be subjected to a Revenue Service tax claim; except that this risk appeared to have been eliminated by the 1950 amendments to the 1939 Revenue Code (citation *infra*) enacted at the Treasury's instance and laying down guidelines for the taxation of rental income used by a foundation to discharge the price for business properties purchased on credit. The parties considered that they had met Congressional and Treasury requirements when they negotiated this transaction to comply with these recently enacted statutory rules.

For the Revenue Service to contend, beginning in 1954 (Rev. Rul. 54-420, 1954-2 Cum. Bull. 128), that the 1953 sale by the Brown Group was not a sale for capital gain tax purposes, is to strike at the integrity of the Rule of Tax Law.

The Court of Appeals for the Ninth Circuit, in a decision which affirmed the Tax Court, and which is in harmony with a number of other decisions and in

conflict with none (citations *infra*), upheld the Rule of Tax Law. By granting the petition of the Revenue Service for certiorari, this Court has undertaken to re-examine the validity of such a Rule.

Statutes Involved.

In addition to Section 117(a)(4) of the 1939 Code and Section 1222(3) of the 1954 Code, referred to by petitioner (Br. 2), reference is made to the following provisions of the Internal Revenue Code of 1939 (26 U. S. C., 1952 Ed.) as amended by Section 301 of the Revenue Act of 1950 (64 Stat. 906):

"*Sec. 101. Exemptions From Tax on Corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—

* * * * * *

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation. For loss of exemption under certain circumstances, see sections 3813 and 3814.

* * * * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are

payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

Supplement U—Taxation of Business Income of Certain Section 101 Organizations.

Sec. 421. Imposition of Tax.

(a) In General—There shall be levied, collected, and paid for each taxable year beginning after December 31, 1950—

(1) upon the supplement U net income (as defined in subsection (c)) of every organization described in subsection (b) (1), a normal tax of 25 per centum of the supplement U net income and a surtax of 22 per centum of the amount of the supplement U net income in excess of $25,000; except that (A) in the case of taxable years beginning before April 1, 1951, and ending after March 31, 1951, the normal tax shall be 28¾ per centum of the supplement U net income, and (B) in the case of taxable years beginning after March 31, 1951, and before April 1, 1954, the normal tax shall be 30 per centum of the supplement U net income.

* * * * *

(c) Definition of Supplement U Net Income—The term "supplement U net income" of an organization means the amount by which its unrelated business net income (as defined in section 422) exceeds $1,000.

* * * * *

Sec. 422. Unrelated Business Net Income.

(a) Definition.—The term "unrelated business net income" means the gross income derived by any organization from any unrelated trade or business (as defined in subsection (b)) regularly carried on by it, less the deductions allowed by section 23 which are directly connected with the carrying on of such trade or business, subject to the following exceptions, additions and limitations;

(1) There shall be excluded all dividends, interests, and annuities, and all deductions directly connected with such income.

(2) There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or net income from the property, and all deductions directly connected with such income.

(3) There shall be excluded all rents from real property (including personal property leased with the real property), and all deductions directly connected with such rents.

(4) Notwithstanding paragraph (3), in the case of a supplement U lease (as defined in section 423 (a)) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under sec-

tion 423 (d) (1) and there shall be allowed, as a deduction, the amount ascertained under section 423 (d) (2).

* * * * *

Sec. 423. Supplement U Lease.

(a) Definition of Supplement U Lease.—The term "supplement U lease" means a lease for a term of more than five years of real property by an organization (or by a partnership of which it is a member), if at the close of the lessor's taxable year there is a supplemental U lease indebtedness (as defined in subsection (b)) with respect to such property.

* * * * *

(b) Supplement U Lease Indebtedness.—The term "supplement U lease indebtedness" means, with respect to any real property leased for a term of more than five years, the unpaid amount of—

(1) the indebtedness incurred by the lessor in acquiring or improving such property:

* * * * *

(c) Personal Property Leased With Real Property.—For the purposes of this section, the term "real property" and the term "premises" include personal property of the lessor leased by it to a lessee of its estate if the lease of such personal property is made under, or in connection with, the lease of such real estate.

(d) Treatment of Supplement U Lease Rents and Deductions.—In computing under section 422-(a) the unrelated business net income for any taxable year—

(1) Percentage of rents taken into account.—There shall be included with respect to each supplement U lease, as an item of gross income derived from an unrelated trade or business, an amount which is the same percentage (but not in excess of 100 per centum) of the total rents derived during the taxable year under such lease as (A) the supplement U lease indebtedness, at the close of the taxable year, with respect to the premises covered by such lease is of (B) the adjusted basis, at the close of the taxable year, of such premises.

* * * * *

The corresponding provisions of the 1954 Code are found in sections 501, 502, and 511-514.

Statement.

Apart from argumentative inferences, Petitioner apparently accepts the fact findings of the Tax Court. [*Cf.* Br. 2-14 with R. 20-57.] These are summarized below. Since a valid purpose of this brief is to acquaint the Court with corollary issues that will be affected by its decision, notably the pending Tax Court case of the Institute, we take the liberty of including in parenthetical italics some facts not of record here but which are expected to be proved in that case.

The Institute was formed as a non-profit charitable corporation in 1945 and took the name "California Institute for Cancer Research" in 1947. Its name was changed to "West Los Angeles Institute for Cancer Research" in 1957. It is described by the Tax Court as "an adjunct of the University of California at Los Angeles." [R. 22-23.]

(Its original members and directors included Dr. Vern O. Knudsen, Dean of the Graduate Division, University of California at Los Angeles, and a number of doctors associated with U. C. L. A. Medical School. Its activities expanded until it became peopled with several hundred volunteer directors, committee members and members of auxiliary organizations, including a number of prominent citizens. It has collected several hundred thousand dollars in donations from the public and other foundations and largely contributed these funds for cancer research. Nearly $200,000 of contributions had been received before the Institute's first purchase-lease transaction in 1951. In addition to collecting funds for and channeling them to worthy cancer research projects, the people of the Institute have devoted much time to furthering cancer research in various ways. For example, they played an important role in securing housing for the cancer wing in temporary buildings during the construction of the Medical Center at U. C. L. A. and have worked with the United States Public Health Service and other organizations to advance this worthy cause.)

(Prior to the summer of 1951 the Institute had become acquainted with transactions which the Loyola Foundation had been making for some years with the advice of a competent tax attorney. Such a transaction involved the credit purchase of a going business by the foundation and the lease of its assets to a new operator, enabling the foundation to pay the price out of a tax-free rental. The Institute was advised that such transactions had been accepted at face value by the Internal Revenue Service and had been expressly sanctioned by 1950 amendments to the Internal Revenue

Code, provided the lease period was limited to five years. In reliance upon the foregoing and upon the advice of the same tax attorney, the Institute entered into two such transactions; one in 1951 for the purchase of a business known as Ward Mayer Structures, Inc.; and the second in 1953 for the purchase of Clay Brown & Company. The Loyola Foundation transactions and the Ward Mayer purchase involved essentially the same pattern as that presented in the purchase of Clay Brown & Company.)

Prior to 1953, all of the stock and $125,000 of notes of Clay Brown & Company were owned by the Brown Group, none of whom had any connection with the Institute. [R. 21, 23, 30.] That Company's lumber milling business was quite successful, having earned about $339,000 a year before taxes over its 2½ year history. [R. 35.] After considerable negotiation the Institute agreed to pay $1,300,000 for the stock and notes, this being less than the asking price and more than the first offer. After deducting an estimated interest factor, this price, amounted to about $1,065,000 for the stock and notes, or $940,000 for the stock alone; it was reasonable and was supported by the earnings record as well as an appraisal of tangible assets by General Appraisal Company. [R. 23-37, 64.] The Institute's officers expected it to be paid in five years. [R. 36.]

(Should rents fall short of the amounts required to pay the purchase price, the directors and officers of the Institute anticipated that they would be able to arrange independent financing in order to complete payment.)

In February 1953, the stock and note purchase and subsequent proceedings were carried out in accordance with a series of legal documents that had been care-

fully drawn and approved by the Brown Group and their attorneys, as well as the Institute's legal committee and directors.[1] [R. 37-44.] The events, in order of occurrence, were as follows:

Sale and transfer of the stock and notes of Clay Brown & Company to the Institute for a price of $1,300,000, payable $5,000 down with a note for the balance due not later than January 1, 1963, bearing interest only after maturity, payable from 90% of rentals received, but not less than $250,000 in each two consecutive years;

Liquidation of Clay Brown & Company and transfer of its assets to the Institute;

Mortgaging of the assets to secure the unpaid price;

Execution of a five-year lease of the real estate, plant and equipment by the Institute to Fortuna, a newly formed company the entire stock of which was owned by Calvin N. Souther and William H. Kinsey, who invested and risked therein $25,000 of their own funds not obtained directly or indirectly from the Brown Group;

Lease provision for a rental of 80% of Fortuna's annual net profits, computed before depreciation and income taxes, but in any event at least $277,778 in each two-year period, the lessee to maintain the premises in good repair and pay taxes and insurance;

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[1]See R. 244-6 for a list of the directors and legal committee of the Institute. Directors included a number of prominent business and professional people, such as the Dean (Dr. Warren) and former Dean (Dr. Knudsen) of U.C.L.A. Medical School. The legal committee was composed of two judges and a practicing attorney.

Sale of the current assets by the Institute to Fortuna at their net book value payable by assumption of the liabilities of the business plus Fortuna's note to the Institute for about $21,000.

During the 1953-57 period Fortuna operated the lumber milling business and paid to the Institute $703,992 of rent, and $12,630 of other amounts including proceeds of a sale of assets. The Institute paid $651,095 to the Brown Group upon the price. [R. 56.] In addition, Fortuna spent significant sums upon the Institute's capital assets and took rental credit therefor, pursuant to a lease provision authorizing $25,000 a year of such expenditure and credit.[2]

In conducting its operations, Fortuna employed the working staff formerly employed by Clay Brown & Company, under the supervision of Souther, Kinsey and a member of their law firm who acted as officers and directors. Clay Brown was general manager for about 21 months and thereafter was retained as an adviser at a reduced salary. Fortuna made 27 bank loans, ranging up to $55,214, of which one was guaranteed by Clay Brown.[3] [R. 41-42, 48-49, 56.]

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[2]Lease and License Agreement, Ex. 49-WW, Sec. 8, R. 218. The amounts so expended presumably are available in the original record, though not revealed by the printed record.

[3]Clay Brown had sufficient interest in his compensation from and his lien upon rental obligations of Fortuna to make such action economically viable; it did not mean that he, or others of the Brown Group who made no such guarantee, were in any sense owners of Fortuna or participants in its profits or losses.

(The unrelenting attacks of the Revenue Service upon the Institute, and upon the parties who made sales to and leases from it, have been ruinous to the Institute's hopes of deriving substantial profit for cancer research from the two purchase-lease transactions.)

(Shortly following the issuance of Rev. Rul. 54-420, the Institute voluntarily went to the Revenue Service for clarification of applicability to the Institute and its transactions. At about the same time there began a long series of negotiations and disputes between the Institute and the other parties, directly consequent upon Revenue Service disapproval of the latters' position as sellers and rent-payers.[4])

(After prolonged discussions with the Revenue Service, the Institute faced withdrawal of its tax exemption, which would have terminated its ability to receive tax deductible donations and killed the activities of its large volunteer organization in collecting them. The law provides no way of testing the validity of such administrative action before its devastating impact. Therefore, the Institute was compelled to reorganize. At the end of 1956, a new non-profit corporation was formed with the name "California Institute for Cancer Research"; the large voluntary organization of the Institute—directors, officers, and committees—shifted to the

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[4]Although the rent deduction of Fortuna has apparently never been questioned, the rent deduction of Timber Structures, Inc. has; the latter corporation is the lessee of the properties acquired by the Institute in the *Mayer* transaction.

new corporation; the Institute changed its name to "West Los Angeles Institute for Cancer Research" and was thereafter managed by a small group of volunteer directors and officers with the objective of defending its assets and, at the end of the trouble, contributing their remainder to the California Institute for Cancer Research.)

(This defense, all directly consequent upon the Revenue Service attack, has wiped out the Institute's substantial cash resources and left it with only a doubtful hope of salvaging some contribution for the charitable purpose.[5])

Summary of Argument.

To save time and space, the Court is respectfully referred to the argument headings in the table of contents for the Summary of Argument for this brief.

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[5]The sellers in the *Mayer* transaction brought suit for rescission based upon tax frustration, although they had not defended their tax position beyond the administrative stage. This exhausting substantive litigation is still not finally resolved. Were the Revenue Service a private party, which thus interfered in the contractual relations of others, it might well be the object of a damage suit.

ARGUMENT.

1. Although This Was a Sale to a Charitable Buyer It Was Within Sound Public Policy.

In 1951, the Institute, a worthy public charity, was seeking to enhance its resources for cancer research. It purchased a business corporation in 1951, and a second one, Clay Brown & Company, in 1953, expecting to pay the price for each out of five years' tax exempt rental from the business properties. It was recognized that some refinancing might be required, but nevertheless believed that shortly after five years, income from the properties or proceeds from their sale would be available for cancer research.

In each instance the sellers were businessmen of the entrepreneur class who had built successful businesses and wanted to receive the fruits of their labors. They were presented with an economic choice commonly faced by businessmen with such a purpose: either to sell for a fixed price and pay capital gain tax upon the profit; or to retain the business and pay ordinary income tax on profit withdrawn. This choice, which is part of the fundamental pattern of our economic life, is the same whether the buyer is or is not a tax exempt organization. It is part of the encouragement to entrepreneurs afforded by our tax laws that they should have this choice, and has been since 1921.[6]

When the Institute became the buyer of Brown & Company, two worthy ends of public policy were

[6]The sellers to Loyola Foundation whose tax cases are cited under Point 4, *infra.*, will be seen also to be businessmen of the entrepreneur class. In this day of big government, big business, and big labor unions, there is a terrible economic squeeze upon the entrepreneur who, singly or with partners, attempts to build a business of his own. He needs all the encouragement he can get.

served: the Brown Group were afforded their choice to sell and take the deserved gain at the deserved capital gain tax rates; the Institute was securing financial resources to further cancer research.

Had the price paid by the Institute been out of line with that customarily commanded by a like business, there might be grounds for suspecting an accommodation designed primarily to thwart tax laws rather than serve legitimate economic and charitable ends. Such, however, was not the case.

The average annual earnings of Brown & Company before taxes were $307,000, unadjusted, or $339,000 after adding back certain capital expenditures. They had been $415,000 in the year ended April 30, 1951, and although there was an intervening drop, appeared to be back to that level for the year ended April 30, 1953. [R. 35.] The price agreed to in the course of extended negotiations was $1,300,000, payable over an expected five years without interest. The interest factor was about $237,000, leaving about $1,065,000 as the principal element, which was not greatly in excess of the appraised value of the tangible assets. [R. 31-32.] In the vital respect of its ratio to earnings, this price was less than eight times after-tax or four times before-tax average earnings; and in terms of the rate of annual earnings at the time of sale, it was less than six to one after taxes or three to one before taxes. It would be a bargain today; particularly so in view of the market-place rule-of-thumb that price

tends to increase in direct ratio to the deferred portion of the payment.

The Tax Court was conservative when it found this price to be "within a reasonable range." [R. 64.]

The significant economic fact about the transaction was: The Brown Group parted with their business for a fair price which, although deferred, was confidently expected to be paid from earnings, from the Institute's independent resources, or both. This was a sale. It is and was within sound public policy to so regard it for tax purposes.

2. The Only Viable Question Is Whether a Charitable Organization Should Enjoy Tax Exemption for Rental Income Used to Purchase Business Properties. This Is a Question of Fiscal Policy to Be Answered by Congress.

Although public policy favors financial encouragement to worthy charities, a question of fiscal policy arises when such charities acquire business properties and enjoy tax exemption for the resulting income. This tends to lessen the revenue and may disturb general business economics. It may permit charities to compete unfairly with privately owned business.

Specifically, it facilitates acquisition of business properties by exempt organizations because, like any other buyer, the charity will bargain in terms of price as a multiple of proven and expected income; but the charity will think in terms of exempt income. This is so regardless of whether the terms are all cash, part

cash, or no down payment; which underscores that the true fiscal problem is not the presence or absence of a down payment.

Whether and to what extent the business income of charities should be taxed is typically a problem for Congress.[7] Congress has, in fact, carefully dealt with that problem.

3. At the Treasury's Instance Congress Amended the Internal Revenue Code in 1950 to Control the Credit Purchase of Businesses by Tax-Exempt Organizations.

For many years prior to 1950 the Treasury had been contesting the right of a charitable foundation to secure tax-free income from a business enterprise, particularly if that income was used by the foundation to purchase the enterprise. After unsuccessful litigation, and an unsuccessful attempt at legislation in 1942, the Treasury was successful in securing remedial legislation in the Revenue Act of 1950. See the discussion of this history in *C. F. Mueller Co. Commissioner,* 14 T. C. 922, 932 (1950), and in the opinion of the Third Circuit Court of Appeals, reversing the Tax Court. 190 F. 2d 120 (1951). See also, *Roche's Beach, Inc. v. Commissioner,* 96 F. 2d 776 (2d Cir. 1938).

The problem was thoroughly analyzed by Congress in 1950. *House Report No. 2319,* Ways & Means Committee, 81st Congress, Second Session, 1950-2 Cum. Bull. 380, 480-411.[8] The Committee refers (p. 409)

[7]As noted by the Court below, R. 295-6. It is the problem to which the commentators direct, or should direct, their attention. See articles cited by the Court below [R. 291] and petitioner (Br. 23, Ftn. 9.)

[8]See also the Senate Committee Report which is generally in accord. Report 2375, 81st Congress, Second Session, 1950-2 Cum. Bull. 483 at 502 *et seq.*

to instances where exempt organizations "have, in effect, used their tax exemption to buy an ordinary business * * * with no investment on their own part and paid for it in installments out of subsequent earnings—a procedure which usually could not be followed if the business were taxable." There is discussion (p. 410) of the purchase-lease situation where the foundation "does not use its own funds" but "borrows the price and pays off this loan" from "rental income received for a period of years" thus obtaining "unencumbered title" although "investing little or nothing in the venture." This is objectionable because the only "contribution" by the foundation "is its tax exemption" and the only reason why it "received the property at no expenses to itself is the fact that it pays no income tax on the rentals received"; that since "borrowed funds may represent 100% of the purchase price" there is no limit to the expansion of ownership by exempt organizations of income producing properties, with consequent shrinkage of revenue; that this may in effect constitute a sale of a foundation's exemption through the means of "paying a higher price" than would be involved if normal taxes applied, but in an area where proof "is difficult to obtain because the purchase price * * * which a taxable business would agree to pay is unknown". The exempt organization "because of its tax free status, can afford to pay the higher price and still make a profit on the transaction. This is especially likely to occur where the exempt organization is presented an arrangement which does not require the commitment of any of its own funds."

The remedy adopted by Congress was not to classify a credit sale to an exempt organization as a non-capital-gain sale, and not to withdraw the organization's ex-

emption, but to tax to the organization rentals from business properties purchased on credit and leased for more than five years.

Specifically Section 101 of the 1939 Code was amended (by Sec. 301 of the Revenue Act of 1950, 64 Stat. 906) by adding at the end paragraphs designed to deny the exemption to an active business feeder corporation, *i.e.*, one operated for the primary purpose of carrying on a trade or business for profit; but this provision states that for its purposes "trade or business shall not include the rental by an organization of its real property (including personal property lessed with the real property)."

The other part of the 1950 amendment was to add Supplement U taxing unrelated business income and providing a complex and precise statutory pattern of taxation of business lease income. Specifically, 1939 Code Section 422(a)(3) excludes from "unrelated business net income" (taxable under Sec. 421) "all rents from real property (including personal property leased with the real property)"; Section 422(a)(4) provides, notwithstanding, that rental from a "supplement U lease" shall be taxed as provided in Section 423; and Section 423 provides that a "supplement U lease" is one for more than five years (*i.e.*, rent from a five year or shorter lease is tax free), that "supplement U lease indebtedness" is indebtedness incurred in acquiring or improving the property, and that rent is taxable in the ratio of year-end supplement U lease indebtedness to adjusted basis of the property.[9] The cor-

[9]If rent had been received by the Institute from Fortuna, after expiration of the five year lease, it would have been taxed under the last mentioned formula. See 1954 Code Sec. 514(b)(2)(B).

responding provisions of the 1934 Code are found in Sections 511-514.

4. The Commissioner Has Not Accepted the Remedy Provided by Congress. Since 1954 He Has Broadly Attacked Exempt Organization Credit Purchase Transactions.

For several years after the enactment of the 1950 amendments the Commissioner did not find fault with transactions like the one before this court, which had been entered into by the Loyola Foundation and the Institute.[10] However, in the fall of 1954 the Revenue Service opened a broad scale attack upon such transactions by issuing Revenue Ruling 54-420 (1954-2 Cum. Bull. 128) which is reproduced in Appendix A to this brief.

Since 1954 the Service has litigated a number of cases involving credit purchase of business properties by exempt organizations, in which it has challenged the exemption of the purchaser and the seller's right to long term capital gain. In this litigation the Commissioner has lost the following imposing list of cases: the decision below; *Union Bank, Executor v. United States,* 285 F. 2d 126 (Ct. Cl. 1961); **Anderson Dairy, Inc. v. Commissioner,* 39 T. C. 1027 (1963);

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[10]Loyola Foundation has made a number of purchase lease transactions involving rentals computed as 80% of the profits of the lessee and requiring payment of 90% of the rentals on the price; some of these antedating the 1950 amendments. It is the writer's understanding that prior to 1954 the Internal Revenue Service audited exempt returns of Loyola Foundation reflecting such transactions and did not disturb them. The writer personally was not involved in the 1951 and 1953 purchases which the Institute made; but early in 1954, on behalf of the Institute, he inquired of the Internal Revenue Service in Washington concerning its attitude toward such transactions and was advised that they were not being challenged.

Estate of Ernest G. Howes v. Commissioner, 30 T. C. 909 (1958), aff'd *sub. nom. Commissioner v. Johnson*, 267 F. 2d 382 (1st Cir. 1959); *W. H. Truschel v. Commissioner*, 29 T. C. 433 (1957), acq. 1960-1 Cum. Bull. 6; *Estate of James L. Hawley v. Commissioner*, 20 T. C. M. 210 (T. C. Memo. Dec. 2/17/61); *Estate of Cordie Hawthorne*, 19 T. C. M. 770 (T. C. Memo. Dec. 6/30/60.); *A Shiffman v. Commissioner*, 32 T. C. 1073 (1959), acq. 1960-1 Cum. Bull. 5; *Ohio Furnace Co. v. Commissioner*, 25 T. C. 179 (1955); *Knapp Bros. Shoe Mfg. Corp. v. United States*, 142 F. Supp. 899 (Ct. Cl. 1956); **Royal Farms Dairy Co. v. Commissioner*, 40 T. C. 172 (1963); **Ralph M. Singer v. Commissioner*, 22 T. C. M. 759 (T. C. Memo. Dec. 6/7/63); **Isis Windows, Inc. v. Commissioner*, 22 T. C. M. 837 (T. C. Memo. Dec. 6/27/63) **Oscar C. Stahl v. Commissioner*, 22 T. C. M. 996 (T. C. Memo. Dec. 6/29/63).[11]

The starred cases, which are on appeal to the Ninth Circuit Court of Appeals, and the *Union Bank* case, involve sales to Loyola Foundation (or University Hill Foundation, as it is now called) upon terms similar to those of the Institute's purchases. In *Estate of Hawley* and *Estate of Hawthorne*, the payment arrangements were also dependent on profits or income. In all of the

[11]A number of the cited decisions, including those here under review, have rightly distinguished *Emanuel N. Kolkey v Commissioner*, 254 F. 2d 51 (7th Cir. 1958, *aff'g* 27 T. C. 37) which involved an essentially sham sale to a feeder corporation created to act as buyer, for an unrealistic price represented by a large note issue, where connection of the exempt organization with the feeder was ownership of a miniscule stock issue that was reacquired by the sellers before the end of the feeder's first fiscal period. This decision illustrates that the Revenue Service has a remedy in this, as in other areas, to prevent tax avoidance through the use of devices without economic significance.

cited cases, regardless of the precise formula for payment, the plan was for the exempt organization to pay the price from the earnings of the business enterprise.

The Commissioner's brief to this Court is singularly silent about the 1950 amendments. Rev. Rul. 54-420 is devoid of reference to them. The Revenue Service wherever possible has avoided mentioning them in the litigated cases, including the proceedings below.

The focal points of the historical picture, then, are: Congress has clearly spoken in 1950 upon the subject of the acquisition of business properties by charitable foundations and payment of the price out of tax-exempt rental; it has recognized that the foundation usually does not commit its own resources or make a down payment; it has carefully spelled out a remedy that does not deny capital gain benefit to the sellers or tax exemption to the buyer but, instead, controls the kind and amount of tax-exempt rental that may be used to pay the price. Nevertheless, the Revenue Service has made a broad scale attack upon the tax advantages that Congress has sanctioned; that attack has been unsuccessful in case after case. This appeal is another phase of that attack.

5. Petitioner Contends That for Tax Purposes Respondents Made a Transfer With Income Retained, Rather Than a Sale. This Is a New Issue Which May Not Be Presented for the First Time in This Court.

This controversy originated with the issuance of Rev. Rul. 54-420 (Appendix A to this brief). Neither the Revenue Ruling nor the deficiency notices in this case gave any legal reason for denying the capital gain bene-

fit. The deficiency notices tax as ordinary income not the full receipts, but only the gain as it would be computed upon a sale. [R. 8-15.]

In the Tax Court the Revenue Service contended that the sale gain here should be denied the capital gain benefits of Section 117(a) of the 1939 Code because of the substantial incidents of ownership retained by the sellers. [R. 58-59.] It also argued that the transaction was a sham, but abandoned that point in the Court of Appeals. [R. 294.]

Here petitioner contends that respondents made a transfer of stock with retained income interest which was not a sale for any tax purpose, and petitioner observes (Br. 71-75) that a remand will be required to try further questions. Petitioner says that as a result of his new theory, it must be assumed that there was either a tax-free organization by respondents of Brown & Company into Fortuna, or a taxable liquidation of Brown & Company attributable to respondents. In either event, he says, respondents may be taxable as having received constructive dividends, in the one alternative from the reorganized corporation, in the other from a thinly-capitalized Fortuna in which respondents have made a constructive capital investment. The taxable amount of the constructive dividends would depend upon "by whose earnings and profits their treatment is governed." (Br. 75.) In the second alternative, the receipts may have constituted rents, not dividends, in which event the net income taxable to respondents would depend upon "what basis respondents may use for depreciation." (Br. 75.)

Thus, petitioner brings his case here upon an issue not presented at the original trial, which would require a new trial of new questions in order to determine re-

spondents' tax liability. This would deny to respondents the justice of repose from repeated litigation of the same dispute. *Burnet v. Commonwealth Improvement Co.*, 287 U. S. 415 (1932); *General Utilities & Operating Co. v. Helvering*, 296 U. S. 200 (1935); *Helvering v. Salvage*, 297 U. S. 106 (1936); *Helvering v. Wood*, 309 U. S. 344 (1940). In *Hormel v. Helvering*, 312 U. S. 552 (1941), this Court (pp. 556-557) said: "Ordinarily an appellate court does not give consideration to issues not raised below"; but permitted presentation of a new issue by the appellant "to promote the ends of justice" because a controlling Supreme Court decision had intervened between trial and appeal.

In this case there is no such justification for presentation of a new appellate issue by petitioner. To permit it would defeat, not serve, the ends of justice.

6. Petitioner Has Presented No Adequate Reason for Unsettling the Meaning of "Sale" in the Tax Statutes or Changing the Rule of Tax Law Upon Which Respondents Relied.

Even if this Court decides to listen, petitioner's new theory must be rejected as untenable. It is contrary to a substantial and uniform body of decisions upholding capital gain treatment for credit sales to tax-exempt organizations (citations under Point 4, *supra*). It is unsupported by any valid analogy from other areas of tax law and is refuted by many such analogies. It would deprive the word "sale" in the capital gain statute of the accepted legal-commercial meaning that it has enjoyed since 1921; it would retroactively tax a bona fide sale made in reliance upon that accepted meaning; it would create chaotic uncertainty as to the applicability of this statute. It would permit administrative legislation.

In short, petitioner's theory would deny reliability of a Rule of Tax Law to taxpayers generally, and would deny its integrity to respondents in this case and others similarly situated.

A. "Sale" in the Tax Statutes Should Not Have an Esoteric Meaning but Should Apply to an Arm's Length Sale at Substantive Law.

The sale here had economic significance, was negotiated at arm's length between strangers, and passed ownership from sellers to buyer for a stated price. It was a sale of stock by the substantive law of the sellers' residence (*Ore. Compiled Laws Ann.* Sec. 78-101) and the buyer's (*Cal. Corp. Code* Sec. 2466). Under such laws, the occurrence of a sale did not depend upon a down payment or the personal liability of the buyer for the price. In fact, California law prohibits enforcement of a purchase money obligation against the buyer of real and personal property (*Code of Civ. Proc.* Sec. 580(b)) and the Oregon law does so for real property (*Ore. Rev. Stats.* Sec. 88.070).

In California, sales occur by the thousands with little or no down payment and no personal liability of the buyer. So far as the writer is aware, the Revenue Service has always treated them as sales for tax purposes, except in its present campaign against sales to exempt organizations.

Petitioner does not deny that this was a substantive sale between strangers, but does deny that it was a sale for tax purposes particularly the purposes of Section 117 of the 1939 Code and Section 1222 of the 1954 Code.

"Sale" is a term of commonly accepted meaning. The current Internal Revenue Code is a complex and detailed statute containing many precise definitions.[12] Unless the statute specifically defines such a common word in some esoteric sense, the Courts certainly should not do so.[13]

B. Petitioner Proposes That the Pattern of Tax Statutes Relating to Sales Should Not Apply to This Substantive Sale.

The capital gain provisions may not sensibly be isolated from the pattern of interwoven tax statutes dealing with sales, exchanges and dispositions. A brief review of the statutory pattern is in order.

Basically, gain or loss from the "sale or other disposition of property" is measured by comparing the "amount realized" with basis; and is recognized upon "the sale or exchange of property" except as specifically otherwise provided. *Secs. 111, 112(a); Secs. 1001, 1002.[14] Exceptions to this rule are carefully spelled out. *Secs. 112(b) *et seq.*; Secs. 1031 *et seq.* 332, 351 *et seq.* Where payment of price is deferred, the seller

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[12]The Revenue Act of 1921 covered 109 printed pages. The current version of the 1954 Internal Revenue Code covers about 1,500 printed pages. All of the intervening years, except 1922 and 1925, have seen new Revenue Acts or amendments to the Revenue Codes and in recent years these have been numerous and voluminous.

[13]*The Hanover Bank v. Commissioner,* 369 U. S. 672 (1962); *Crane v. Commissioner,* 331 U. S. 1 (1947). In *Helvering v. Flaccus Oak Leather Co.,* 313 U. S. 247 (1941), this Court applied the stated principle to the words "sales or exchanges" in the capital gain and loss statute.

[14]Section references in this subdivision are to the Internal Revenue Codes of 1939 and 1954, the starred references being to the 1939 Code. Starred regulation references are to Regs. 118 under the 1939 Code.

may elect to report gain (but not loss) by the installment method. *Sec. 44; Sec. 453. The regulations lay down careful rules surrounding the installment election and the consequences of repossession. *Reg. 39.44; Reg. 1.453. The buyer of property is given a basis of "cost", that is, price paid. *Sec. 113(a); Sec. 1012. Gain from the "sale or exchange" of capital assets is taxed at a reduced rate and the deduction of loss therefrom is carefully restricted. *Sec. 117; Secs. 1201-1212, 1221-1223, 1231 *et seq.*

Petitioner's contention that the transaction here was a transfer with retained income, and his reliance upon the analogy of the oil and gas cases, apparently would remove this transaction from the entire statutory pattern pertaining to sales. Petitioner could not well contend, for example, that respondents were subject to tax upon gain from a sale that is recognized as such under *Section 112, while also proposing that the periodic payments to them should be taxed as retained income.

Petitioner faces unsurmountable difficulties with his proposed interpretation.

C. The Oil Interest Cases Upon Which Petitioner Relies Are Not Analogous to a Credit Sale of Non-Depletable Property. The Tax Consequences of the Latter Cannot Sensibly Depend Upon the Buyer's Down Payment or Personal Liability.

In his contention that the Brown Group for tax purposes made an income retained transaction, not a credit sale of the stock of Brown & Company, petitioner relies primarily upon an anlogy to decisions involving depletable interests in oil properties.

The fundamental problem in the oil cases is that the capital investment in the oil is converted into money only through a piecemeal sale of the capital asset itself. The depletion allowance[15] was granted by Congress "on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit" and "is designed to permit a recoupment of the owner's capital investment" therein; however, the allowance "bears little relationship to the capital investment" and "continues so long as minerals are extracted, and even though no money was actually invested in the deposit."[16] In light of "complexities of oil operations and risks incident to prospecting" leading to "intricate, multiparty transactions" the problem has been "to determine which parties are entitled to a part of the allowance" where the "statute merely provides" that it "should be 'equitably apportioned between the lessor and lessee' ".[17]

"Congress", this Court has observed, "has recognized the peculiar character of the business of extracting natural resources" and accordingly made provision "for equitable apportionment of the depletion allowance".[18] "As the oil is extracted and sold" the interest of each participant "is reduced" thereby entitling him to "his equitable proportion of the depletion".[19] This Court has also said that Congress "cannot be taken to have

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[15]1954 Revenue Code, Secs. 611, 613; 1939 Code, Secs. 23(m), 114(b)(3).

[16]*Commissioner v. Southwest Exploration Company*, 350 U. S. 308, 312 (1956).

[17]*Id.* p. 313.

[18]*Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25, 33-34 (1946).

[19]*Id.* p. 35.

intended that an oil and gas lease under the capital gains provision, any more than a mineral lease under the earlier acts, should be treated like an ordinary sale of land or chattels."[20]

In facing the transfer of an oil property along with tangible equipment, for a royalty interest and cash, this Court has distinguished the retention of the depletable oil interest, a nontaxable event, from the sale of the depreciable equipment, which was a taxable event resulting in a deductible loss.[21]

Petitioner brushes lightly over *Helvering v. O'Donnell*, 303 U. S. 370 (1938) (Ftn. 26, Br. 47-48) as "all but overruled",—hardly a warrantable conclusion in view of its continued citation by this Court. That case is embarrassing to petitioner because it held that a sale of stock of an oil corporation in return for payments to be measured by profits from the corporation's oil properties was a sale, not a retention of depletable interest. It made a correct distinction. Before the stock sale the corporation, not the shareholder, was entitled to depletion on the oil interest; money could come to the shareholder only through taxable dividends or a taxable sale or disposition of his shares. When the shares were sold, the corporation continued to own the depletable oil interest, unless the buyer of the shares dissolved the corporation and acquired that interest, which event would not *ipso facto* pass the depletable interest back to the seller of the shares.

Each owner of an oil interest continues to draw his income and deduct his depletion until his interest is paid

[20] *Burnet v. Harmel*, 287 U. S. 103, 108 (1932).

[21] *W. G. Choate v. Commissioner*, 324 U. S. 1 (1945); *cf. Thomas v. Peckham Oil Co.*, 115 F. 2d 685 (CCA 5th, 1940).

out or exhausted, at which point nothing transfers to a new owner; there is never a sale.

By contrast, where ordinary business properties are sold for a deferred price they are transferred to a new owner, not exhausted. The sale is effective under both substantive and tax law, when title "passes" or when "possession and the burdens and benefits of ownership are * * * transferred * * * whichever occurs first".[22] As a matter of timing, the effective date is not postponed until payment of the deferred price has been completed; but even if it were, there would at the latter date necessarily be a transfer of ownership—*i.e.*, sale—of properties which, in this era of expansion and inflation, probably have become more valuable with the passage of time.

Consequently, there is no sensible analogy from the oil interest concept to the credit sale of nondepletable property, and the attempt to draw one merely creates strange problems.

For example, consider a California shopping center, built with borrowed funds on a 99-year leasehold, and sold several times at increasing prices as its success is demonstrated. It may well be that neither the original owner nor any subsequent buyer has paid any substantial cash for his acquisition. The insurance company that holds the first mortgage has waived any personal liability,[23] and the junior purchase money mortgages involve none. All of the credit is at risk upon the shop-

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[22]0.988, Cum. Bull. No. 2, p. 84 (1920). This venerable revenue ruling is still generally followed.

[23]This is standard procedure. Alternatively, the borrower may use a corporate front to insulate himself.

ping center and its future.[24] Commercially, and in the eyes of the Revenue Service, each of the transfers of equity has effected a sale, with all of the complex tax results that follow under the statutory pattern. Taxpayers and Service alike would be dismayed now to learn that there were no taxable sales; no changes in depreciation base; instead, the mortgage holders, along with the last equity owner, all have ownership and income interests of some peculiar sort.

Petitioner's argument is so absorbed in its analogy to depletable assets that it fails to analyze the tax consequences of a successful credit sale of nondepletable property. In fact, most of such sales do pay out even though the buyer has not made a down payment or incurred personal liability. This was or will be the result in most of the sales to foundations involved in the cases cited under Point 4, *supra*. It was the expected result in the instant case.

Let us think in terms of two no-down-payment sales, in each of which the buyer has completed payment of the price; the seller no longer has any claim upon the property. One of such sales was made in California, which permits no deficiency judgment on foreclosure; the other was made in State X, which permits a deficiency judgment. Petitioner would not deny that the sale in State X had tax validity. (Br. 49.) The seller would have paid tax at the capital gain rate, probably upon the installment basis; at the date of the sale, the buyer would have secured a basis equal to the price.

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[24]In the normal transaction, this is wholly or largely the case; the equity money, if present, is of minor credit significance.

Even though in both California and State X the property has been sold and paid for in transactions that are commercially and legally identical, petitioner would have us give strange treatment to the California seller and buyer. The seller, not the buyer, would be taxable on income from the property during the pay-out period, and the buyer would have a zero basis.[25] A host of collateral questions are raised: Is the seller's basis amortizable against payments or deductible at some point as capital loss,[26] and would this change if his basis were equal to or greater than selling price? Would the transaction be converted to a taxable sale if the buyer paid out before maturity by refinancing or using his own funds? Would the seller be taxable upon payments made in a period when the buyer had no taxable income, and would the buyer have a carry-over or carry-back deduction against income of a different period? What of payments having their economic source in property additions paid for by the buyer or in the buyer's services—would these be price or income to the seller? If the buyer resold subject to the unpaid first mortgage and took payment by second mortgage, would this, too, be a transfer with retention of income? Would the new buyer be denied any basis, even in the amount of the first mortgage?[27]

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[25]This Court has noted that its distinction between the nature of payments as price, on the one hand, or return of income, on the other, "affects both the operators who make them and the owners, lessors, vendors, grantors, however they may be classed, who receive them. If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other." *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. at p. 27.

[26]Petitioner's emphasis upon the dividends-income concept of the seller's position suggests that the seller's basis would not be amortizable against payments as received.

[27]Contravening *Crane v. Commissioner*, 331 U. S. 1 (1947).

There is no basis in the economics or in substantive law to distinguish between the State X sale and the California sale. It is not clear that the revenue would be augmented by petitioner's peculiar treatment of the latter.

It is certain that the complex pattern of the tax statutes cannot possibly accommodate petitioner's suggested treatment. If this Court were to adopt it, the Revenue Service, taxpayers, and other courts would be left in a never-never land of writing tax law from case to case.[28]

D. The Substantive Sale by Respondents Was Made in Reliance Upon an Historic Acceptance of the Commercial Meaning for "Sale" in the Tax Statutes, Particularly the Installment Sale Provisions.

It is obvious that the Brown Group would not have made a deferred price sale of the Brown & Company stock to the Institute, or to any other buyer, had they anticipated in 1953 that it might later be interpreted to be an income-retention transaction. At the time of their sale, there was a well-settled acceptance of the commercial meaning of "sale" for tax purposes,[29] and no inkling of the special exception that petitioner now urges. Even after the 1954 issuance of Rev. Rul. 54-420 there was no warning that the capital gain treatment was in jeopardy for credit sales, unless made to a tax-exempt organization.

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[28]Although petitioner does not forewarn the Court of the terrifying tax complications faced by his retained income transactions, he does admit that a case-by-case analysis will be necessary to distinguish them from sales. (Br. 58.)

[29]Except for specific statutory exceptions or additions, *e.g.*, 1939 Revenue Code Secs. 117(f)-117(p).

Acceptance for the tax statutes of the commercial meaning of "sale" is so old and widespread that one may see its evidence almost everywhere and its contradiction almost nowhere.[30] This acceptance has not been altered because the price, or part of it, was dependent upon future income from the property sold, and therefore at risk.[31] The Revenue Service has been at pains to reinterpret a deferred payment (lease) transaction as a sale for tax purposes because that assertedly was its commercial substance.[32]

The area of tax law having particular interest for the Brown Group in 1953 pertained to installment sales, and it was squared off with sharp corners.

As interpreted by Regs. 118, Sec. 39.44-2(c), the installment method of reporting was unavailable unless there was at least one payment in the year of sale, and at least one payment subsequent thereto. The technical-mechanical nature of this requirement was explained in G. C. M. 12148, XII-2 Cum. Bull. 57 (1933). The Brown Group had to be careful to secure a small down payment.

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[30]See, for example: *Helvering v. Hammel*, 311 U. S. 504 (1941); *Spring City Foundry Co. v. Commissioner*, 292 U. S. 182 (1934); *Ohio Brass Co. v. Commissioner*, 17 B. T. A. 1199 (1929), *acq.* IX-2 Cum. Bull. 45; *Rialto Mining Corp. v. Commissioner*, 25 B. T. A. 980 (1932), *acq.* XI-1 Cum. Bull. 6; G. C. M. 12012, XII-2 Cum. Bull. 60 (1933); G. C. M. 21503, 1939-2 Cum. Bull. 205. *Cf. Le Tulle v. Scofield*, 308 U. S. 415 (1940).

[31]*Helvering v. O'Donnell*, 303 U. S. 370 (1938); *Burnet v. Logan*, 283 U. S. 404 (1931); *Vermont Transit Co., Inc. v. Commissioner*, 218 F. 2d 468, 469-70 (2d Cir. 1955), *cert. denied* 349 U. S. 945; Rev. Rul. 58-353, 1958-2 Cum. Bull. 408; Rev. Rul. 60-226, 1960-1 Cum. Bull. 26. *Cf.* 1954 Revenue Code, Sec. 1235.

[32]Rev. Rul. 55-541, 1955-2 Cum. Bull. 19; Rev. Rul. 55-540, *id.* p. 39; Rev. Rul. 57-371, 1957-2 Cum. Bull. 214. *Cf.* 1954 Revenue Code, Sec. 162(a)(3); 1939 Code, Sec 23(a)(1)(A).

Failure to comply with the strict installment election requirements meant accrual of the entire gain in the year of sale regardless of the amount of deferred price.[33] Even where collectibility was seriously doubtful, the issue judicially considered was not whether a sale had occurred but whether the taxpayer could defer reporting gain until after recovery of basis; the focal point of the enquiry was whether the property sold had sufficient value to secure the purchase money debt.[34]

The 1954 Code specifically permits reporting a sale by the installment method, even if there are no payments in the year of sale. Section 453(b)(2). The Committee Report states that this change was to avoid leaving "in doubt, for perhaps a number of years, the status of certain sales in which the initial payments are indefinite and are not payable until some time subsequent to the year of sale."[35]

The rules laid down for the Brown Group specified not only that they had made a taxable installment sale, but also that they would face a second taxable event upon repossession; Regulations 39.44-3(b) would have

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[33]*Pacific National Co. v. Welch*, 304 U. S. 191 (1938); *Peter Mamula v. Com.*, 41 T. C. 572 (1964) (on appeal to Ninth Circuit); *John W. Commons v. Com.*, 20 T. C. 900 (1953), *acq.* 1954-1 Cum. Bull. 4; *Albert Vischia v. Com.*, 26 T. C. 1027 (1956); *Sarah Briarly v. Com.*, 29 B. T. A. 256 (1933); *W. T. Thrift, Sr. v. Com.*, 15 T. C. 366 (1950); *Susie Ackerman v. United States*, 318 F. 2d 402 (10th Cir. 1963).

[34]*Estate of E. P. Lamberth v. Com.*, 31 T. C. 302 (1958), *acq. and nonacq.* 1959-1 Cum. Bull. 4 and 6; *Biscayne Bay Islands Co. v. Com.*, 23 B. T. A. 731 (1931), *acq.* XI-1 C. B. 2; *Key Largo Shores Properties, Inc. v. Com.*, 21 B. T. A. 1008 (1930), *nonacq.* X-1 Cum. Bull. 84; *Ives Dairy, Inc. v. Com.*, 23 B. T. A. 579 (1931), *aff'd* 65 F. 2d 135 (5th Cir. 1933); *Morgan Rundel v. Com.*, 21 B. T. A. 1019 (1930); *Saunders v. United States*, 101 F. 2d 133 (5th Cir. 1939).

[35]Sen. Rep. No. 1622, 83rd Cong. 2d Sess. 64.

taxed as gain the difference between fair market value of the repossessed property and the unexhausted basis in the deferred price obligation.[36] In fact, the Brown Group never did effect a foreclosure-repossession of the mortgaged assets, but instead permitted the Institute to retain and sell them and remit only 90% of the sale proceeds toward the unpaid portion of the original price. [R. 52-57.]

It would be a shocking miscarriage of justice if petitioner were permitted retroactively to interpret respondents' 1953 installment sale into an income retention transaction, in the teeth of many years of general and unqualified tax acceptance of such a sale for installment and capital gain purposes. If petitioner succeeds here, untold numbers of other transactions would also be subjected to *ex post facto* taxation.

E. If a Remedy Is Needed, Congress Should Provide It. Petitioner's Proposal For Court Action Would Take From an Accepted Rule of Tax Law the Reliability That It Deserves for the Future and the Integrity That It Deserves for the Past.

Viewed realistically, petitioner's argument here is a valiant attempt to furnish some support for the Revenue Service condemnation of credit sales to exempt organizations which began with Rev. Rul. 54-420. That ruling gave no legal reason for its position. See last paragraph, Appendix A, p. 5. Petitioner presents no sensible legal reason.

The Treasury recently asked Congress to enact specific legislation which would have been very similar to

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[36]And so it continued under Regs. 1.453-5(b), implementing the 1954 Revenue Code. A 1964 amendment to the 1954 Code has established a new rule for repossession of real estate. Section 1038 as added by P. L. 88-570, Section 2(a).

petitioner's theory. With respect to the 1963 Tax Bill, which became the Revenue Act of 1964, Secretary Dillon proposed to Congress[37] that payments on the sale of a capital asset which were "deferred over more than 5 years and * * * contingent on future income be treated as ordinary income". The purpose was to prevent a taxpayer from enjoying capital gain rates where he continued to possess "the principal right of ownership —participation in the income produced by the asset" or by "the income-producing property underlying the asset sold". He explained that a "payment would be regarded as so contingent on future income if it were contingent on productivity, sales, profitability, use or disposition of the asset sold or the underlying property"; and that his proposal would cover a "sale of stock in a corporation where payment is contingent on dividends on the stock or productivity of the corporate assets".

No such provision was incorporated into the Revenue Act of 1964, although Section 224 of that Act did add Code Section 483, effective with respect to sales made after June 30, 1963, providing for ordinary income taxation of the interest increment of deferred payments. The amendment, says the Committee Report, has taken into account the situation "Where, at the time of the sale or exchange, some or all of the payments are indefinite as to their size; for example where the payments are in part at least dependent upon future income derived from the property * * *"[38]

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[37]Page 91 of the Statement by Secretary of the Treasury and Technical Explanation on President's Tax Reduction and Reform Message, presented to the Ways and Means Committee on February 6, 1963.

[38]General explanation of H. R. 8363, Revenue Bill of 1963 (1964), Report of House Ways and Means Committee, p. 73, Report of Senate Finance Committee, p. 103.

It is evident that:

Congress in 1950 reviewed the subject of credit sales to exempt organizations where the price was to be paid from future income, and enacted specific remedial provisions which respondents relied upon and conformed to in making their 1953 sale;

Congress in 1963-64 reviewed the general subject of credit sales where the price is to be paid from future income, and provided a specific statutory remedy that declined a Treasury proposal like that made here;

Petitioner's proposal here would change the meaning of the statutory word "sale" from the normal commercial meaning it has enjoyed for over 40 years to an esoteric and uncertain meaning that respondents could not have anticipated when they made their 1953 sale.

Under circumstances very similar to those here present, the Treasury's arguments were rejected by this Court in *Hanover Bank v. Commissioner,* 369 U. S. 672 (1962).

This Court noted (p. 687) the "firmly established principle of statutory interpretation * * * that 'the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses.' *Crane v. Commissioner,* 331 U. S. 1, 6 * * *"; said (p. 682) that although the Government's complaint about a loophole "might have been persuasive in securing enactment of the amendments to the statute made subsequent to the time the transactions involved here took place * * * it may not, of course, have any impact upon our interpretation of the statute under review";

and commented (p. 684): "* * * it is worthy of note that Congress understood the operation of the statute to the taxpayer's advantage, but limited correction of the abuses inherent in it * * *".

Remarking (p. 686) that "the language of the statute" and "regulations contained not the slightest hint of the distinction urged" by the Treasury, and (p. 688) that "an informed Congress" had acted "with full realization" of the operation of the stataute "but chose not to make any distinction" of the kind urged by the Treasury, this Court concluded (p. 687): "* * * we are not at liberty, notwithstanding the apparent tax-saving windfall bestowed upon taxpayers, to add to or alter the words employed to effect a purpose which does not appear on the face of the statute." *Accord, United States v. Cumberland Public Service Company,* 338 U. S. 451, 455-456 (1950); *Helvering v. Flaccus Oak Leather Co.,* 313 U. S. 247 (1941).

If the Treasury still wants to provide special rules restricting capital gains for credit sales with price payable from future income, it should renew with Congress the subject of particular amendments to that end.[39] If it wants to narrow the tax benefits available to exempt organizations that make such purchases, it should ask Congress to reconsider the 1950 amendments.

The Treasury should not ask this court to so unsettle the long-accepted meaning of a statutory word as to destroy the future reliability of this Rule of Tax Law, and deprive it of integrity for respondents and others who have depended upon it in the past.

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[39]The generic treatment has been a particular code provision. See Sections 165(g) and 1231-1250 of the 1954 Revenue Code.

Conclusion.

The decision below should be affirmed.

Respectfully submitted,

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October 29, 1964.

APPENDIX A.

Rev. Rul. 54-420
1954-2 Cum. Bull. 128

Regulations 118, Section 39.101(6)-1:

Religious, charitable, scientific, literary, and educational organizations and community chests.
(Also Section 421, Section 39.421-1; Section 422, Section 39.422-1; Section 3814, Section 39.3814-1.)

A foundation which acquires all of the outstanding stock of a business corporation, dissolves the corporation and sells, leases, or licenses the assets to an operating company, receiving a substantial portion of the profits of the operating company and using those profits to liquidate the indebtedness incurred in acquiring the business, is not engaged in activities coming within the contemplation of section 101(6) of the Internal Revenue Code of 1939.

If the foundation were otherwise exempt under section 101(6) of the Code, the receipt of rents and royalties by it from the lease and license agreements with the operating company do not fall within the meaning of the exceptions to "unrelated business net income" as set forth in section 422 of the Code, and such rents and royalties would be subject to tax under section 421 of the Code. Moreover, in such a case the provisions of section 3814 of the Code may be applicable on the ground that the foundation is unreasonably accumulating income if it uses a large part of its income to retire indebtedness incurred in the acquisition of income producing property.

Advice is requested whether a foundation is entitled to exemption from Federal income tax under the factual circumstances described below.

The foundation in the instant case was incorporated for scientific, charitable, educational, and religious purposes. The foundation proposes to acquire all the outstanding capital stock of a business corporation, dissolve the corporation, receive the assets and sell, lease or license the assets to an operating company. The operating company will then enter into a management contract with the original stockholder. Part of the current assets will be transferred to the operating company (subject to liabilities), and the remaining assets (exclusive of patents) will be leased to the operating company for a term of 5 years. A part of the consideration to be received by the foundation for the current assets will be evidenced by a promissory note of the operating company, payable without interest on or before the termination of the 5-year lease. The annual rental under the lease will be equal to 10 percent of the annual net income of the operating company before Federal and State income, franchise, excess profits and other similar taxes.

The patents received by the foundation upon liquidation of the corporation will be licensed to the operating company for annual royalties equal to 70 percent of the annual net income of the operating company before such taxes. The period of the license was not definitely fixed and may be in excess of 5 years.

An initial payment to the original stockholder under the agreement will be made from the assets received by the foundation upon liquidation of the corporation and the balance will be paid at the rate of 90 percent of the rental income and royalties received by the foundation for the lease of the fixed assets and the license of the patents.

As security for the note evidencing the unpaid balance under the agreement, the foundation will give the original stockholder a first mortgage on all real estate and buildings and a chattel mortgage on all the other tangible assets received by the foundation, except the current assets transferred to the operating company. As further security, the foundation will give to the original stockholder a conditional assignment of patents, a conditional assignment of the foundation's interests as lessor in the lease and license to the operating company, and the note of the operating company evidencing the consideration received for the current assets. The foundation will have no liability whatsoever for payment of the unpaid balance except out of the assets (including income therefrom) received upon liquidation of the corporation.

Section 101(6) of the Code provides for the exemption from taxation of:

> Corporations and any community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, * * * no part of the net earnings of which inures to the benefit of any private shareholder or individual. * * *

Under the circumstances of the instant case it is the position of the Internal Revenue Service that the foundation is not engaged exclusively in activities coming within the contemplation of section 101(6) of the Code.

If the foundation were otherwise exempt under section 101(6) of the Code, the amounts termed rents and royalties received by it under the instant lease and license agreements would be considered to be income

from an unrelated trade or business subject to the Supplement U tax imposed by section 421 of the Code. Section 422 of the Code, which excepts royalties and certain rents from the definition of "unrelated business net income," is not applicable to the instant case. Section 39.422-1(b) of Regulations 118 states that whether a particular item of income falls within the meaning of the exceptions, additions, and limitations provided in section 422 of the Code shall be determined by all the facts and circumstances of each case. For example, if a payment termed "rent" by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or a joint venturer, such payment does not qualify as rent for purposes of the exception in section 422-(a) of the Code.

Attention is also called to section 3814 of the Code which denies exemption under section 101(6) of the Code to certain organizations if the amounts accumulated out of their income, which are not actually paid out for exempt purposes by the end of the taxable year, are unreasonable, or if such accumulated income is used to a substantial degree for purposes other than those constituting the basis of the organization's exemption. Where an organization, which claims exemption under section 101(6) of the Code and is not excepted from the provisions of section 3814 of the Code, uses income to retire indebtedness incurred in the acquisition of income producing property or business, thereby increasing its equity, it is accumulating income within the meaning of section 3814. The question as to whether the income accumulated is unreasonable for the

purpose of such section is not one susceptible of resolution by a general statement, but is dependent upon the particular facts and circumstances in each case.

Transactions of the type involved in this case also present a serious question as to the essential nature of the agreement entered into by the foundation. It is the position of the Service that in cases of this general nature, the amounts received from the foundation in fulfillment of the terms of the agreement will not be recognized as proceeds from a sale requiring capital gain treatment.